Office-Supreme Court, U.S.
FILED
MAR 12 1962
JOHN F. DAVIS, CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1961.

No. 790

D. LOVEMAN & SON EXPORT CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

and

D. LOVEMAN & SON, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Sixth Circuit.

RICHARD KATCHER,
1130 B. F. Keith Building,
Cleveland 15, Ohio,
Counsel for Petitioners.

THE GATES LEGAL PUBLISHING CO., CLEVELAND, OHIO—MAIN 1-5847

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To the United States Court of Appeals For the Sixth Circuit.

Petitioners pray that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Sixth Circuit, entered in the above cases on December 16, 1961, which cases involve identical questions.

CITATIONS TO OPINIONS BELOW.

The opinion of the Tax Court of the United States is reported at 34 T. C. 776 (1960). The opinion of the United States Court of Appeals for the Sixth Circuit, printed in Appendix, *infra*, p. 12, has not yet been reported.

JURISDICTION.

The order of the United States Court of Appeals for the Sixth Circuit, affirming the decision of the Tax Court of the United States, was entered on December 16, 1961. The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1).

QUESTIONS PRESENTED.

Petitioners are engaged in the steel warehouse business of buying, processing and selling primarily carbon steel plates. Their regular sources of supply for their inventory requirements have always been the major steel mills. Since incorporation, each petitioner has used the lower of cost or market method in pricing its inventory. Consistently, and in accordance with the custom of the industry, petitioners determined the "market" of their inventory by reference to the published mill prices of the major mill producers.

Petitioners' regular sources of supply were temporarily not available to them from December, 1951, to September, 1953, because of unusual circumstances beyond their control. Therefore, in 1951, 1952 and 1953, petitioners purchased their inventory requirements from smaller mills at premium prices which were higher than the published prices of the major mills. Petitioners valued their inventory on the basis that the major mills represented their market. Since the published prices of the major mills were lower than petitioners' costs, the lower market prices were used. These valuations resulted in a reduction of petitioners' ending inventories, thereby reducing their taxable income.

The questions presented are:

1. What is the meaning of "market" as employed in the inventory method of "the lower of cost or market"?

2. Were petitioners, in applying the inventory method of the lower of cost or market, entitled to use as their market that of the major mill producers, their regular sources of supply, since that market was lower than petitioners' cost for their inventory?

STATUTES AND REGULATIONS INVOLVED.

Section 22(c) of the Internal Revenue Code of 1939 and the pertinent portions of U. S. Treasury Regulations 111, Section 29.22(c)-2 and -4 (1943) and U. S. Treasury Regulations 118, Section 39.22(c)-2 and -4 (1953) are printed in Appendix, *infra*, pp. 12-18.

STATEMENT OF THE CASE.

Petitioners, D. Loveman & Son, Inc. (hereinafter referred to as "Domestic"), and D. Loveman & Son Export Corporation (hereinafter referred to as "Export") are Ohio corporations, each having its principal office in Bedford Heights, Ohio, and each employing an accrual method of accounting. Domestic reports its income on a calendar year basis, and Export uses a fiscal year ending August 31. (R. 195a.)

Domestic, incorporated in 1946, and Export, incorporated in 1947, are engaged in the steel warehouse business of buying, processing and selling steel materials. Approximately 90% of the steel products sold by Domestic consisted of sheared carbon steel plates. Since incorporation, each has used the lower of cost or market method in pricing its inventories. (R. 196a.)

Since its incorporation, the market value of the first quality steel of Domestic has been determined by reference to the prevailing mill price of the major producers as published in Iron Age Magazine, a widely read weekly trade magazine whose published prices have been stipu-

lated by the parties hereto to be true and correct. The major mill producers, such as Jones & Laughlin Steel Corporation, Republic Steel Corp. and Bethlehem Steel Corporation, were Domestic's customary sources of supply. (R. 197a, 200a.) It is customary in the steel warehouse industry to determine the market value of first quality inventory by reference to the published mill price of the major producers regardless of the source from which the steel was purchased. (R. 59a-60a, 81a-82a.)

In the fall of 1951, the Korean War had created a shortage of steel supply in relation to demand, which impaired Domestic's ability to purchase steel from its regular sources of supply. With the development of the steel shortage, Bethlehem Steel Corporation stopped shipping steel to the Cleveland, Ohio, area, and the other major producing mills refused to sell to Domestic because their product was already spoken for by virtue of allocations and priorities to other customers. (R. 197a-198a.)

The inability of Domestic to purchase steel from its customary sources of supply forced Domestic to look to other sources for its steel. In the fall of 1951, Domestic established contact with Central Iron and Steel Corporation of Harrisburg, Pennsylvania (hereinafter referred to as "Central"). Central was located in the same geographical area as the major mill producers from whom Domestic had previously purchased its inventory. It was one of a number of so-called premium mills; a name given a mill which in periods of short supply charges prices higher than those of the major producing mills. From December, 1951, through December, 1953, most of Domestic's steel purchases were made from Central. (R. 198a.)

At the beginning of 1951, Central had a rated annual capacity to produce 182,400 net tons of sheared carbon steel plate, or about 3% of the total industry rated ca-

pacity of 6,888,650 net tons. The average value of all carbon steel plates shipped in the United States (other than interplant transfers) in 1951 and 1952, including shipments by the major producing mills and the premium mills, was approximately $4.40 and $4.45 per cwt., respectively. (R. 201a-202a.)

The following table reflects, on the applicable inventory dates, the published mill price of the major producers and of Central, Domestic's cost range of first quality steel plate and Domestic's inventory price based on the lower market of the major producers:

	Published Mill Price Per Cwt. of			
Date	*Major Producers*	*Central*	*Domestic's Cost Range*	*Domestic's Inventory Price*
12 31 51	$3.70	$6.75	$5.00-8.50	$3.75
12 31 52	3.90	6.50	5.00-7.20	3.90
12 31 53	4.10	4.10	4.95-7.60	4.10

The market value of all the first quality steel in Domestic's inventory on each of December 31, 1951 (with one exception), 1952, and 1953, was determined in exactly the same manner that the market value of its steel had been consistently determined in prior years; namely, at the published mill price of the major producing mills as reflected in the issue of Iron Age Magazine closest to the applicable December 31. The market price so determined, being lower than Domestic's cost, was used in valuing Domestic's inventory at the lower of cost or market. (R. 201a, 203a, 209a.)

The major producing mills also served as Export's customary source of supply, but as of the spring of 1953, Export was unable to obtain any steel from those mills although the demand for steel had declined. Consequently, in June, 1953, Export purchased structural steel products in Europe. By the close of Export's fiscal year ended

August 31, 1953, some of the steel purchased in Europe was in Export's warehouse and the remainder was en route. In taking inventory as of August 31, 1953, the items in Export's warehouse were determined to be first quality steel, and it was assumed that the merchandise in transit also was first quality. (R. 214a-215a.)

For purposes of computing the lower of cost or market, Export customarily determined the market value of its first quality steel by reference to the published mill price of the major mill producers for the type of steel involved. On August 31, 1953, the steel that Export had on hand had an average inventory cost to it of $5.79 per cwt. The prevailing published mill prices of the major mill producers for the structural steel products constituting Export's inventory were $4.15 and $4.10 per cwt. On the basis of these major mill prices, market was lower than cost and accordingly was used in pricing Export's fiscal 1953 inventory. (R. 215a.)

The Tax Court held that Domestic as of December 31, 1951, and December 31, 1952, and Export as of August 31, 1953, were required to value their first quality steel at cost rather than at the lower published price of the major producing mills. With respect to Domestic's first quality steel inventory on December 31, 1953, the Commissioner of Internal Revenue, on brief before the Tax Court, conceded that it should be valued at the published price of the major producing mills, which price was lower than Domestic's cost for its inventory. The Court of Appeals for the Sixth Circuit affirmed the Tax Court's decision.

REASONS FOR GRANTING THE WRIT.

The meaning of "market" as employed in the lower of cost or market method of inventory valuation has not been subjected to judicial inquiry. The importance to the administration of the income tax laws of such an inquiry is readily demonstrable.

The most common method employed by business in the pricing of inventory is cost or market, whichever is lower. In 1950 (the year immediately preceding the first year here in issue), statistics reveal that approximately 70% of the corporate income tax returns filed with balance sheets employed the lower of cost or market method of inventory valuation. Such returns reflected inventory valuations of $36,283,712,000. Statistics of Income for 1950, Part 2, United States Treasury Department, Internal Revenue Service (1954), pp. 28-36.

Accordingly, the effect of inventory methods and valuations on the revenue of the United States and on the administration of its tax laws is apparent. The problems in this area have recently taken on new significance.

President Kennedy, in his Message on Taxation delivered to the Congress of the United States on April 20, 1961, stated:

> "It is increasingly apparent that the manipulation of inventories has become a frequent method of avoiding taxes. Current laws and regulations generally permit the use of inventory methods which are acceptable in recognized accounting practice. Deviations from these methods, which are not always easy to detect during examination of tax returns, can often lead to complete non-payment of taxes until the inventories are liquidated; and, for some taxpayers, this represents permanent tax reduction. The understating of the valuation of inventories is the device most frequently used.

"I have directed the Internal Revenue Service to give increasing attention to this area of tax avoidance, through a stepped-up emphasis on both the verification of the amounts reported as inventories and an examination of methods used in arriving at their reported valuation."

Secretary of the Treasury Dillon explained President Kennedy's Recommendations with respect to the valuation of inventory in these words:

"Understatement of the ending inventory may be accomplished by manipulation of the code provision permitting inventories to be valued at cost or market, whichever is lower. The use of very low market values, of course, reduces the amount of the ending inventory, thereby reducing taxable income. In addition, the amount of the ending inventory may be understated by not including therein a proper count of all inventory items.

"In order to assist in correcting abuses in the inventory area, taxpayers might be required to report in the tax return the cost of the closing inventory before any reductions to market. The taxpayer would then separately state the amount of any inventory valuation deduction. If market values are used for any items of inventory, the taxpayer would be required to explain on what basis the market value was determined and the relationship of recent purchases and sales to that market value." Hearings Before the Committee on Ways and Means of the House of Representatives on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961, 87th Cong., 1st Sess. pp. 295-296 (1961).

Internal Revenue Service quickly took administrative action. The 1961 income tax returns propound the following question, among others, with respect to inventory:

"3. If inventory is valued at lower of cost or market, enter total cost $ and total market valuation $ of those items valued at market."

Instructions for the preparation of 1961 income tax returns state that the taxpayer is required to attach to the return a "detailed explanation of the method used to establish market valuations." See "Your 1961 U. S. Corporation Income Tax Return, Form 1120 and Instructions," p. 3.

In a Technical Information Release (TIR 354, January 3, 1962), the Commissioner of Internal Revenue stated that where the information required of taxpayers who value inventory by the lower of cost or market method is not furnished, the likelihood is strong that their returns will be selected for examination.

The increased emphasis to be placed on inventory valuation and methods is unmistakable. However, taxpayers who, like the petitioners, employ the lower of cost or market method and who desire to value correctly their inventory are not furnished any guides with respect to the meaning of "market". U. S. Treasury Regulations 118, Section 39.22(c)-4, *infra*, pp. 17-18, simply provide that "market" means replacement price. But replacement price where? From the regular sources of supply or from the particular source from which the purchase of inventory could be made at the valuation date?

In the instant cases, petitioners valued their inventory at the lower of cost or market and looked to the published mill prices of the major mill producers—their regular and normal sources of supply—for the determination of market. This was the custom in the industry, even in the situation in which petitioners involuntarily found themselves; that is, where they were temporarily locked out of their regular and normal sources of supply and were

forced to buy their inventory requirements elsewhere at a higher price.

Suppose a taxpayer's regular source of supply is Republic Steel Corp. On June 1, it is unable to purchase its particular requirements from that mill. It is, however, successful in purchasing steel from a foreign source. On December 31 of that year, its inventory valuation date, the taxpayer is in a position to purchase that type of steel from its regular source of supply, Republic Steel. Is the "market" of the steel purchased from the foreign source its then replacement cost at that source, or is "market" that of Republic Steel?

If on valuation date a taxpayer has in inventory identical steel purchased from each of a foreign source and Republic Steel at different prices, what is its market? Does it have as many markets as it has sources of supply?[1]

These are some of the questions with which taxpayers who employ the lower of cost or market method are confronted. These questions should not be left to interpretations of the lower courts and Internal Revenue Service that assuredly will result in inconsistency, confusion and considerable expense both to taxpayers and the Government. Because of the emphasis now to be placed on inventory methods and valuations, taxpayers employing the lower of cost or market method and the Government will benefit from a definitive statement from this Court that will produce a solution to the perplexing question of what is market.

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[1] The provision in U. S. Treasury Regulations 118, Section 39.22(c)-4(c), (Appendix, *infra*, p. 18) that the market value of each item in the inventory is to be compared with its cost and the lower of such values taken as the inventory value presupposes that "market" is known. It does not offer any clue or solution to the legal question, "What is Market?"

This Court should enunciate a definition of "market" to serve as a standard to be applied by the lower courts, the Tax Court and Internal Revenue Service in dealing with the inventory method of the lower of cost or market.

CONCLUSION.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

RICHARD KATCHER,
1130 B. F. Keith Building,
Cleveland 15, Ohio,
Counsel for Petitioners.

APPENDIX.

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(December 16, 1961.)

Before MARTIN, WEICK and O'SULLIVAN, Circuit Judges.

The above causes came on to be heard upon the record, briefs and arguments of counsel, and upon due consideration thereof, it is the opinion of this Court that the decision of the Tax Court should be affirmed. The opinion of the Tax Court adequately reviews the factual background of the litigation and we agree with the conclusions of the Tax Court as expressed in the able opinion of Judge Arnold Raum, which is reported as 34 T. C. 776 (1960).

IT IS, THEREFORE, ORDERED that the decision of the Tax Court be, and the same is, hereby affirmed.

Approved for entry.

United States Circuit Judge.

STATUTES AND REGULATIONS.

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the

best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * *

Treasury Regulations 111 (1939 Code):

Sec. 29.22(c)-2 *Valuation of Inventories.*—Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22(c) are (a) cost and (b) cost or market, whichever is lower. (For inventories by dealers in securities, see section 29.22(c)-5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be

valued at bona fide selling prices less direct cost of disposition, whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. * * *

* * * * *

Sec. 29.22(c)-4 (Original, Oct. 26, 1943). *Inventories at Cost or Market, Whichever Is Lower.*—Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(a) Of goods purchased and on hand, and

(b) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.

Where no open market exists or where quotations are nominal, due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or

others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

Treasury Regulations 118 (1939 Code):

Sec. 39.22(c)-2 *Valuation of inventories.*—(a) Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method

of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

(c) The bases or valuation most commonly used by business concerns and which meet the requirements of section 22(c) are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see § 39.22(c)-5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether basis (1) or (2) is used, or if such goods consisted of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. * * *

Sec. 39.22(c)-3 *Inventories at Cost.*—Cost means,

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods,

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added

transportation or other necessary charges incurred in acquiring possession of the goods.

* * * * *

Sec. 39.22(c)-4 *Inventories at cost or market, whichever is lower.*—(a) Under ordinary circumstances and normal goods in an inventory, "market" means the current bid price prevailing at the date of inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(1) Of goods purchased and on hand, and

(2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.

(b) Where no open market exists or where quotations are nominal, due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer

for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.